Supreme Court, U.S.
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No. 98-1278

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

SEKO INVESTMENT, INC.,

Petitioner,

v.

CHICAGO TITLE INSURANCE COMPANY,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Where respondent, who is petitioner's sole creditor, petitions for involuntary bankruptcy of the petitioner-debtor based upon a debt consisting of two promissory notes indisputably in default, did the court of appeal correctly hold that the petitioner-debtor's counterclaim separate and distinct from the debt alleged in the bankruptcy petition (*i.e.*, the petitioner-debtor's allegation of insurance bad faith based upon an owner's title insurance policy) does not give rise to a "*bona fide* dispute" such as to deprive the respondent-creditor from standing to petition for involuntary bankruptcy under section 303(b) of the Bankruptcy Code?

PARTIES TO THE PROCEEDING

The parties to this proceeding are petitioner, Seko Investment, Inc. (hereinafter, "Seko"), and respondent, Chicago Title Insurance Company (hereinafter, "Chicago Title").

Respondent, Chicago Title Insurance Company, is a wholly-owned subsidiary of Chicago Title and Trust Company, and Chicago Title and Trust Company is in turn a wholly-owned subsidiary of Alleghany Corporation. Alleghany Corporation is the only affiliate of respondent, Chicago Title Insurance Company, which issues shares to the public.

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OPINIONS AND ORDERS ENTERED IN THIS ACTION

The only opinion before this Court for review is that filed by the United States Court of Appeals for the Ninth Circuit filed on September 28, 1998, at its No. 96-56508, and reported as *In re Seko Investment, Inc.*, 156 F.3d 1005 (9th Cir. 1998).

The Ninth Circuit's opinion is its final disposition on appeal from the unpublished memorandum and notice of entry of judgment by the United States Bankruptcy Appellate Panel (hereinafter, "BAP") of the Ninth Circuit filed on August 26, 1996, at its No. CC-95-01029-MeJO.

The BAP's memorandum is its final disposition on appeal from an unpublished memorandum and order of the United States Bankruptcy Court for the Central District of California filed on December 20, 1994, at No. LA 93-29235 TD, on cross-motions for summary judgment.[1]

Well after the bankruptcy court's December 20, 1994 order was appealed to the BAP, which resulted in the opinion by the Ninth Circuit presently before this Court, the

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1. Seko's petition erroneously refers to the December 20, 1994 memorandum and order (Appendix E) of the bankruptcy court as having been filed on August 28, 1996. Petition at 1, ¶ 6. Also, Seko's reference to the transcript of the October 20, 1994 hearing before the bankruptcy court (petition at 1, ¶ 5) is improper and misleading, because only the final order of the bankruptcy court filed on December 20, 1994, and not any judicial act at a prior hearing, was before the BAP on appeal. This Court should, therefore, disregard Seko's Appendix D.

bankruptcy court entered another order two years later on December 30, 1996. That order was appealed to the United States District Court for the Central District of California, and on July 15, 1998 that court rendered an unpublished memorandum and order, at its No. CV 97-0733 JGD.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over this action pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED IN THE CASE

This action involves construction of the following emphasized portion of section 303(b) of the Bankruptcy Code, which section relates to involuntary petitions in bankruptcy:

> (b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title--
>
> (1) by three or more entities, each of which is either a holder of a claim against such person that is *not contingent as to liability or the subject of a bona fide dispute*, or an indenture trustee representing such a holder, if such claims aggregate at least $10,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;
>
> (2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable [citations omitted], by one or more of such holders that hold in the aggregate at least $10,000 of such claims.

11 U.S.C. § 303(b) (emphasis added).

The petition refers to rule 1011 of the Bankruptcy Rules as one of the "statutes" involved. Petition at 3-4. Rule 1011, however, was not at issue in the courts below; the Ninth

Circuit's published opinion which Seko requests this Court to review merely cites rule 1011 in passing but does not construe it, *In re Seko Investment, Inc.*, *supra*, at 1008 n. 3; and the language or construction of the rule was not essential to the opinion of the court below.

STATEMENT OF THE CASE

The Ninth Circuit accurately summarizes the facts and procedural history in its opinion, *In re Seko Investment, Inc.*, *supra*. The key legal and factual issue is that the debt upon which Chicago Title filed its involuntary bankruptcy petition against Seko arose from two promissory notes that lenders assigned to Chicago Title, and not anything else. Seko never disputed that those notes were in default. In this Court, Seko reargues the same points made to and rejected by the Ninth Circuit, namely, that Seko's unproven allegation of insurance bad faith against Chicago Title arising from an insurance policy – and not the debt alleged in the petition – may be asserted as a general counterclaim against Chicago Title, and the existence of such a counterclaim constitutes a "*bona fide* dispute" under § 303(b) which deprives Chicago Title of standing to bring the bankruptcy petition.

Seko's entire argument in the petition before this Court is premised upon an alleged (and unproven) setoff that does not arise from the debt put at issue by Chicago Title's bankruptcy petition. Seko asks this Court to accept review here to disturb an emerging and consistent line of cases which holds that in order to defeat a creditor's standing to petition for involuntary bankruptcy, the debtor's counterclaim must dispute directly the *bona fides* of the debt alleged in the bankruptcy petition. To deprive a creditor of standing under § 303(b), the debtor must demonstrate the debt is either "contingent as to liability" or is "the subject of a bona fide dispute." It is insufficient to defeat the creditor's standing for the debtor merely to allege a counterclaim that the creditor is liable to the debtor on a separate contract or tort, whether the debtor asserts the counterclaim by setoff or otherwise. Such a counterclaim may,

of course, be tried in the same bankruptcy proceeding the creditor initiated, but the separate, non-debt-related counterclaim does not preclude the creditor's standing to the bring the petition in the first place.

The courts around the country which have considered the issue have uniformly rejected Seko's argument, and no reason exists for this Court to issue the extraordinary writ of *certiorari* when the law is consistent and harmonious.

Chicago Title commenced this action by filing an involuntary petition against Seko for liquidation under chapter 7 of the Bankruptcy Code, based upon Seko's default on the two promissory notes assigned by lenders to Chicago Title prior to the filing of the petition. Payment on the notes was secured by real property. Seko admitted default on the notes and the amount of its liability thereunder.

Although Chicago Title issued several title insurance policies with respect to the real property, no debt arising under any title insurance policy is alleged in the petition.

Separate and apart from the promissory notes the lenders assigned to Chicago Title, Chicago Title issued two *lenders'* title insurance policies to the lenders, and, after Seko obtained title to the property by forging a deed, Chicago Title issued an *owner's* title insurance policy to Seko.[2] When the

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2. Seko states, "Seko's title to the real property failed." Petition at 9, ¶ f. This is misleading. Seko forged the title, and that forgery was instrumental in its scheme of fraud. Seko did not lose title as the result of a fortuity or the intervention of another person, however. Seko never had lawful title; it forged

true owner of the property discovered the fraud scheme, Seko stopped paying on the notes, Chicago Title paid the lenders' title insurance claims on the lenders' title insurance policies, and Chicago Title rescinded the owner's title policy issued to Seko.[3]

Chicago Title sued Seko in state court to confirm the rescission and to recover damages for the fraud. In the state court action, Seko counterclaimed for insurance bad faith. Chicago Title then filed the involuntary petition in bankruptcy that commenced the present action. Thereafter, the state court awarded Chicago Title a substantial judgment ($2,348,394) against Seko, and dismissed Seko's frivolous insurance bad faith counterclaim.

The bankruptcy court held Chicago Title's bankruptcy claim against Seko on the debt arising from the promissory notes to be "contingent as to liability," but not "the subject of a bona fide dispute," and dismissed Chicago Title's involuntary bankruptcy petition on the ground Chicago Title had no standing under § 303(b). On appeal, the BAP held the converse: It held Chicago Title's bankruptcy claim was not

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an instrument. Thus, as the Ninth Circuit observed, no loss ever arose under the owner's title insurance policy issued to Seko. *In re Seko*, *supra*, at 1009.

3. Seko again misstates the facts. Chicago Title did not pay the debt Seko owed on the promissory notes. Petition at 9, ¶ h. Rather, Chicago Title paid insurance claims on the lenders' title insurance policies. Acquiring a separate bundle of rights, Chicago Title was assigned the lenders' rights to sue Seko on the unpaid and defaulted promissory notes.

"contingent," but was subject to a "*bona fide* dispute," thereby depriving Chicago Title of standing to petition for involuntary bankruptcy.[4]

The Ninth Circuit, in the opinion before this Court, correctly found that the debt consisting of Seko's obligation on the promissory notes, upon which the bankruptcy petition was based, was neither "contingent as to liability" nor "the subject of a bona fide dispute," and thus, Chicago Title had standing to petition for involuntary bankruptcy of Seko under § 303(b). *In re Seko*, *supra*, at 1008, 1010. The Ninth Circuit's opinion makes clear that it carefully and correctly distinguished the debt that formed the basis of the bankruptcy petition from any other contract or tort liability that Seko as the debtor may allege as a counterclaim arising from any other source, such as the frivolous insurance bad faith counterclaim later dismissed by the state court.

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4. The only issue before the Ninth Circuit and this Court on the present petition relates to the "*bona fide* dispute" criterion of § 303(b), and not the "contingent as to liability" criterion.

REASONS FOR DENYING THE PETITION

This Court should deny the petition simply because it presents no conflict in the decisions between or among the United States courts of appeals, entails no substantial federal question not adequately and accurately resolved by the court's opinion below, and does not meet any of the other discretionary criteria for this Court's review by *certiorari* prescribed by rule 10 of the Rules of the Supreme Court of the United States.

As discussed below, the Ninth Circuit's opinion is entirely consistent with other courts of appeal, the district courts, and the bankruptcy courts which have addressed the issue. Seko's citation to *Harris v. Capehart-Farnsworth Corp.*, 225 F.2d 268 (8th Cir. 1955), to argue that a "clear conflict . . . in at least one other circuit" exists, petition at 6, ¶ 1, is remarkably unpersuasive. The Eighth Circuit's 1955 opinion in *Harris* significantly pre-dates Congress' 1978 enactment of the present version of § 303 involved in this action. 11 U.S.C. § 303 (West 1988, historical notes). Also, *Harris* does not hold that the creditor's involuntary bankruptcy petition should be dismissed based on a counterclaim by the debtors. Rather, the court holds the debtors are entitled to trial on their counterclaim along with the petitioning creditors' claims of debt:

> [T]he alleged bankrupts should have the opportunity at the trial to establish, if they can, that they have set-offs or counterclaims which they are lawfully entitled to use in diminution or extinguishment of the claims of the three petitioning creditors against whom such counterclaims are asserted.

Id. at 270.

Most importantly, the opinion does not indicate whether the debtors' counterclaims arose from the same debts which were put at issue by the creditors' involuntary petition, or from separate theories of the creditor's alleged liability. That is the crucial point. As held by the Ninth Circuit in the opinion below, the debtor's "*bona fide* dispute" to defeat the creditor's standing under § 303 must go the very debt which forms the basis of the bankruptcy petition – and not a separate and collateral counterclaim the debtor may have against the petitioning creditors. Thus, the scant reference to counterclaims in *Harris* is of little help to Seko. The case's silence on the critical legal and factual issue in this case, and the fact that it was decided well before the language construed by the court below even existed does not crystallize into a conflict between circuits which would make this Court's review necessary or appropriate.[5]

Seko quotes extensively from *In re Sims*, 994 F.2d 210 (5th Cir. 1993), falsely arguing its reasoning was "apparently rejected by the Ninth Circuit." Petition at 7, ¶ 2. The crux of the holding of *Sims* is that "[u]nder [an] objective standard, the bankruptcy court must 'determine whether there is an objective basis for either a factual or a legal dispute *as to the validity of the debt*,'" plainly referring to the specific debt alleged in the creditor's involuntary bankruptcy petition. *Id.* at 220, quoting

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5. Seko argues the Ninth Circuit's opinion below "created a new general rule of law, not recognized in any other circuit," and "*Harris* has been cited favorably in a number of more recent cases," petition at 6, ¶¶ 1, 3, but Seko does not favor the Court with any citations to such cases.

from *In re Rimell*, 946 F.2d 1363, 1365 (8th Cir. 1991) (emphasis added). The Ninth Circuit's opinion below falls into line with every other court that has considered the standing issue under § 303(b): The criterion of "*bona fide* dispute" under § 303(b) deals with the debtor's dispute that goes to the debt alleged in the petition, which dispute if *bona fide* may defeat the creditor's standing. The debtor's general right to assert defenses or counterclaims against the creditor, arising from liabilities, disputes, or unproven allegations other than the debt forming the basis of the petition, does not relate to the creditor's standing and therefore, is not a "*bona fide* dispute" within the meaning of § 303(b).

Seko's petition nowhere cogently describes, nor even cites, opinions from the "five Circuits" which Seko argues to disagree with the court below. Petition at 9, ¶ 3. Indeed, Seko cannot do so. The Ninth Circuit's opinion is perfectly consistent with the other courts that have considered this standing issue.

SUMMARY OF ARGUMENT

This Court is asked to review whether Chicago Title's standing to petition for involuntary bankruptcy of Seko under 11 U.S.C. § 303(b) may be precluded by Seko's spurious counterclaim of insurance bad faith, a counterclaim which was legally impermissible for Seko to bring and which was ultimately adjudicated against Seko. The plain fact is that Chicago Title's petition is based on a debt consisting of two promissory notes assigned by lenders to Chicago Title. It is not based on any insurance policy or any insurance claim, nor upon any other contract- or tort-based claim Seko may have had against Chicago Title. A debtor's counterclaim is not a "*bona fide* dispute"under § 303(b), unless the counterclaim disputes the debt alleged in the bankruptcy petition.

As a matter of California law, Seko had no right to raise "insurance bad faith" to fabricate a dispute as to the debt which formed the basis of the petition, because the subject matter of the petition was not in any way an insurance policy to which Seko was a party. Chicago Title did not petition on an insurance contract, but even if it had by way of subrogation of the lenders' rights, those rights would have been derived from *lenders'* title insurance policies to which Seko, as the *owner*, was never a party. As a matter of evidence, Seko failed to demonstrate any such counterclaim.

As a matter of federal bankruptcy law, even if Seko legally and factually had a counterclaim, it arose out of other contract or tort liabilities Seko alleged Chicago Title owed, and thus, is not a "*bona fide* dispute" to preclude an involuntary bankruptcy petition under § 303(b).

ARGUMENT

I. THE DEBTOR'S ALLEGED COUNTERCLAIM OF INSURANCE BAD FAITH ON ITS OWNER'S TITLE INSURANCE POLICY IS, AS A MATTER OF LAW, SEPARATE AND DISTINCT FROM THE DEBT UPON WHICH THE CREDITOR PETITIONED FOR INVOLUNTARY BANKRUPTCY, AND THEREFORE, CANNOT CREATE A "*BONA FIDE* DISPUTE" AS TO THAT DEBT.

The core issue in this case is whether Chicago Title may be deprived of its right to petition for involuntary bankruptcy merely because Seko frivolously cries "insurance bad faith" on an insurance policy unrelated to the debt upon which Chicago Title petitioned.[6] Seko argues that the theoretical possibility that it could sue Chicago Title for insurance bad faith and recover more in amount than the debt alleged by the bankruptcy petition, that constitutes a "counterclaim" which *ipso facto* creates a "*bona fide* dispute" to defeat the creditor's standing under § 303(b).

Although the term "*bona fide* dispute" is not defined in the Bankruptcy Code, *see*, *Bartmann v. Maverick Tube Corp.*, *supra*, 853 F.2d at 1543, the emerging trend of the cases is to apply an objective factual and legal test to determine whether the debtor has raised a *bona fide* dispute to challenge the debt alleged in the creditor's petition. Attesting to the absence of conflict among the federal circuits, a succinct formulation of the analytical methodology is summarized by the Tenth Circuit:

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6. *See*, *Walbrook Ins. Co. v. Liberty Mut. Ins. Co.*, 5 Cal.App.4th 1445, 1455, 7 Cal.Rptr.2d 513, 515 (1992).

> "[T]he bankruptcy court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of debt." *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987). The court need not determine the probable outcome of the dispute, but merely whether one exists. *Id.* Once the petitioning creditor establishes a prima facie case that its claim is not subject to a *bona fide* dispute, the burden shifts to the debtor to present evidence of a bona fide dispute. . . . Under this objective approach the debtor's subjective intent does not control whether a claim is considered to be subject to a bona fide dispute. *In re Tikijian*, 76 B.R. 304, 314 (Bkrtcy.S.D.N.Y. 1987).

Bartmann v. Maverick Tube Corp., *supra*, 853 F.2d at 1544.

It is only upon the separate *owner's* title insurance policy Chicago Title issued to Seko that any conceivable claim of insurance bad faith could lawfully have arisen – whether *bona fide*, or, as in this case, contrived. It is legally impossible for Seko to have had an insurance bad faith claim based upon separate lenders' title insurance policies issued to lenders or upon the promissory notes, and thus, it is legally impossible for Seko to have had any "*bona fide* dispute" as to the promissory notes upon which Chicago Title commenced the involuntary bankruptcy proceeding below.

First, even if the *lenders'* title insurance policies were somehow mixed with the promissory notes upon which Chicago Title petitioned, which is what Seko attempts to do (petition at

10, ¶ 2), Seko has no legal right whatsoever to bring an insurance bad faith case upon insurance policies to which Seko was not a party. Under California law, a stranger to an insurance contract, even if that person were to have a claim against the insured named in that contract, has no cause of action for insurance bad faith against the insured's insurer. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 46 Cal.3d 287, 250 Cal.Rptr. 116, 758 P.2d 58 (1988).[7] The lenders' policies cover the lenders' interests in title to the property. Seko could not even theoretically assert a claim under those lenders' policies, and therefore, could not possibly have had a counterclaim related to the debt alleged in the bankruptcy petition under those policies.

Second, to state a rather obvious point, an insurance bad faith claim cannot be based on an instrument that is not an insurance contract. *Foley v. Interactive Data Corp.*, 47 Cal.3d 654, 254 Cal.Rptr. 211, 765 P.2d 373 (1988). Under California law, no cause of action exists for wrongful denial of the existence of a contract in general. *Freeman & Mills, Inc. v. Belcher Oil Co.*, 11 Cal.4th 85, 44 Cal.Rptr.2d 420, 900 P.2d 669 (1995). And, apart from an insurance contract, the California Supreme Court has repeatedly rejected attempts to infuse contractual relationships with tort liabilities and remedies. *Foley v. Interactive Data Corp.*, *supra* (employment); *Hunter v. Up-Right, Inc.*, 6 Cal.4th 1174, 26 Cal.Rptr.2d 8, 864 P.2d 88 (1993) (misrepresentations inducing termination of employment); *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal.4th 503, 28

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7. *Accord*, *Coleman v. Gulf Ins. Group*, 41 Cal.3d 782, 226 Cal.Rptr. 90, 718 P.2d 77 (1986); *Murphy v. Allstate Ins. Co.*, 17 Cal.3d 937, 132 Cal.Rptr. 424, 553 P.2d 584 (1976).

Cal.Rptr.2d 475, 869 P.2d 88 (1994) (interference with one's own contract).

Finally, even if Seko believed it had a claim of insurance bad faith against Chicago Title based on the *owner's* title insurance policy issued to Seko, then as a matter of California insurance law Seko must demonstrate that Chicago Title breached *that* insurance contract. Without breach of the insurance contract by the insurer, the insured has no cause of action in tort for breach of the implied covenant. *Waller v. Truck Ins. Exchange, Inc.*, 11 Cal.4th 1, 44 Cal.Rptr.2d 370, 900 P.2d 619 (1995).[8] Seko's own fraud and forgery precludes its right to claim under the owner's title insurance policy. *See, Simmons v. California Institute of Technology*, 34 Cal.2d 264, 275, 209 P.2d 581, 588 (1949) (contracts in general may be rescinded for fraud); *Merced County Mut. Fire Ins. Co. v. California*, 233 Cal.App.3d 765, 771, 284 Cal.Rptr. 680, 683-684 (1991) (insured's fraud warrants rescission of insurance contract); *Osborne v. Cal-Am Financial Corp.*, 80 Cal.App.3d 259, 266, 145 Cal.Rptr. 584, 588 (1978) (same).

As a matter of law, Seko's counterclaim of breach of an insurance contract and insurance bad faith can relate only to the

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8. *Accord, Love v. Fire Ins. Exchange*, 21 Cal.App.3d 1126, 1151, 271 Cal.Rptr. 246, 255 (1990); *Tomaselli v. Transamerica Ins. Co.*, 25 Cal.App.4th 1766, 1771, 31 Cal.Rptr.2d 224, 227 (1994); *Brodkin v. State Farm Fire & Cas. Co.*, 217 Cal.App.3d 210, 218, 265 Cal.Rptr. 710 (1989); *California State Auto. Assn. v. Superior Court*, 184 Cal.App.3d 1428, 1433, 229 Cal.Rptr. 409, 412 (1986); *Kopczynski v. Prudential Insurance Co.*, 164 Cal.App.3d 846, 849, 211 Cal.Rptr. 12, 14-15 (1985).

insurance contract that existed between Seko and Chicago Title, but nothing in Chicago Title's petition for involuntary bankruptcy asserts a debt grounded upon Seko's title policy. Therefore, it is legally impossible for Seko to assert a counterclaim of insurance bad faith relating to the debt alleged in the bankruptcy petition.

II. THE DEBTOR'S THEORETICAL COUNTERCLAIM AGAINST THE PETITIONING CREDITOR DOES NOT CREATE A "*BONA FIDE* DISPUTE" WITHIN THE MEANING OF § 303(b).

A debtor's counterclaim grounded on tort or contract liability separate from the debt alleged in the bankruptcy petition, assuming *arguendo* such a counterclaim exists and it is *bona fide* by any definition, as a matter of federal bankruptcy law does not defeat the standing of a creditor to file a petition for involuntary bankruptcy under § 303(b). Consistent with the weight of authority, the Ninth Circuit below correctly holds "that 'the debtor's assertion of counterclaims, even if of substance, does not render the [creditor]'s claim the subject of a bona fide dispute." *In re Seko Investment, Inc.*, *supra*, 156 F.3d at 1008, quoting with approval from *In re Drexler*, 56 B.R. 960, 969 (Bkrtcy.S.D.N.Y. 1986), and citing other cases. The debtor's dispute must go to the merits of the creditor's right to receive payment *on the debt alleged in the petition*. *Atlas Mach. & Iron Works, Inc. v. Bethlehem Steel Corp.*, 986 F.2d 709 (4th Cir. 1993). No court holds that the debtor's counterclaim which does not challenge the debt alleged by the creditor in the bankruptcy petition, can constitute a § 303(b) *bona fide* dispute of the debt. And Seko cites no such holding in its petition.

Several courts have followed the formulation of what constitutes a "*bona fide* dispute" described in *In re Lough*, 57 B.R. 993 (Bkrtcy.E.D.Mich. 1986), wherein a bank filed an involuntary petition against the debtor premised on two debts. One was a note signed jointly with her husband, and the other was a guaranty. Unlike Seko, the debtor disputed both debts, arguing that foreclosure of a mortgage used to secure the note extinguished both debts. The *Lough* court developed a test of objectivity to decide whether the debtor had a "*bona fide* dispute" *as to the debt put at issue in the petition*, and not any collateral counterclaim the debtor might have.

> The legislative history [of § 303] makes it clear that Congress intended to disqualify a creditor whenever there is any legitimate basis for the *debtor not paying the debt*, whether that basis is factual or legal. . . . Accordingly, if there is either a genuine issue of material fact *that bears upon the debtor's liability*, or a meritorious contention as to the application of law to undisputed facts, then the petition must be dismissed.

Id. at 997 (emphasis added).

Seko's only defense is that it had a separate, distinct, collateral, and unproven counterclaim which, if Seko could have won in the state court, would have created a setoff against the debt upon which Chicago Title filed the petition. Seko may acquire a setoff "if the counterclaim is proven," but that cannot create a "*bona fide* dispute" under § 303 to defeat Chicago Title's petition. *In re Data Synco, Inc.*, 142 B.R. 181, 182 (Bkrtcy.N.D.Ohio 1992). On facts similar to those at issue in

this case, courts have consistently held that a counterclaim does not constitute a *bona fide* dispute of the debt alleged in the involuntary petition.

The Fifth Circuit adopted the *Lough* court's objective test in *Matter of Sims*, 994 F.2d 210 (5th Cir. 1993), on facts similar to the case at bar, but with the opposite result. In *Sims* the creditor's debt claim in the bankruptcy petition was based upon the debtor's default on two contracts, a sublease and an equipment lease, in connection with a Subway Restaurant franchise. The debtor, on the other hand, had a counterclaim relating to "development agent work." *Id.* at 213.

> Under that objective standard, the bankruptcy court must "determine whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt." *In re Rimell*, 946 F.2d 1363, 1365 (8th Cir. 1991) [*cert. denied.*, 504 U.S. 941, 112 S.Ct. 2275, 119 L.Ed.2d 202 (1992)].

Matter of Sims, *supra*, at 221.

Noting "the debtors failed to meet their burden of presenting evidence demonstrating the existence of a bona fide dispute," *id.*, the Fifth Circuit concluded, "Contrary to the debtors' assertions, their mere filing of such counterclaims against the creditors [in response to the creditors' prior state-court action] is insufficient to demonstrate the existence of a bona fide dispute," *id.* at 222.

In *Bartmann v. Maverick Tube Corp.*, *supra*, one of the petitioning creditors based its claim against the debtor on a

continuing guaranty executed by the debtor. The debtor argued against that very debt, claiming it "was not continuing and did not transfer to" the assignee-creditor who petitioned. *Id.* at 1542. As to that creditor, the Tenth Circuit analyzed the guaranty, determined it was enforceable, and held the debtor's contrary argument did not create a *bona fide* dispute to deprive the creditor of standing to file the involuntary petition. *Id.* at 1546.

The facts in *In re Rimell*, *supra*, were more compelling for the debtor than those Seko can muster in the present proceeding. The Eighth Circuit approved of the bankruptcy court's evaluation of the legal sufficiency of the debtor's claim of *bona fide* dispute. In that case, as here with the two promissory notes at issue, "the parties did not dispute 'the amounts due, the genuineness or the terms of the guarantees, or the effect of their terms.'" *Id.* at 1365. After hearing the debtors' evidence that the petitioning banks had entered into an oral agreement with the debtors to allow them to change the terms of the loan, the bankruptcy court concluded no such oral agreement had ever been made. The Eighth Circuit affirmed, therefore, holding that no *bona fide* dispute existed as to the debt upon which the creditors petitioned. *Id.* at 1366. The Third Circuit reached a similar result in *B.D.W. Associates, Inc. v. Busy Beaver Bldg. Centers, Inc.*, 865 F.2d 65 (3d Cir. 1989); *accord*, *In re Elsa Designs, Ltd.*, 155 B.R. 859 (S.D.N.Y. 1993).

The mere existence of a counterclaim cannot create a *bona fide* dispute under § 303(b) unless it goes to the merits of the debt upon which a creditor petitions.

> Initially, we would note that [the creditor] is correct in stating that many bankruptcy courts have held that the mere existence of a counterclaim is insufficient to create a bona fide dispute. *See e.g. In re Data Synco, Inc.*, 142 B.R. 181 (Bkrtcy.N.D.Ohio 1992), *In re Onyx Telecommunications, Ltd.*, 60 B.R. 492, 498 (Bkrtcy.S.D.N.Y. 1985). Moreover, *it is clear that if at least a portion of the debt that is the subject of the petition is undisputed, the undisputed portion is sufficient to create a debt under Section 303(b)(1) not subject to a bona fide dispute. See In re Willow Lake Partners II, L.P.*, 156 B.R. 638, 643 (Bkrtcy.W.D.Mo. 1993), *In re F.R.P. Indus., Inc.*, 73 B.R. 309, 312 (Bkrtcy.N.D.Fla. 1987), *In re Onyx*, 60 B.R. at 497.

IBM Credit Corp. v. Compuhouse Systems, Inc., 179 B.R. 474, 479 (W.D.Pa. 1995) (emphasis added; footnote omitted).

Other courts have reached precisely the same conclusion. *IBM Credit Corp. v. Compuhouse Systems, Inc.*, *supra* (debtor's defense consisting of creditor's affiliate's breach of a separate agreement does not create a *bona fide* dispute of the debt); *In re Fox*, 162 B.R. 729 (Bkrtcy.E.D.Va. 1993) (creditor's violation of the Equal Credit Opportunity Act in making the loan does not create a *bona fide* dispute as to the debt); *In re J. B. Lovell Corp.*, 88 B.R. 459 (Bkrtcy.N.D.Ga. 1988) (debtor's counterclaim of creditor's antitrust violations does not affect the creditor's right to be paid on the debt); *In re Ross*, 63 B.R. 951, 964 (Bkrtcy.S.D.N.Y. 1986) (debtor's counterclaim that a securities broker mishandled the debtor's

accounts in prior years does not create a *bona fide* dispute to the broker's involuntary petition based on a deficit in debtor's margin account).

Cases which hold that the debtor raised a *bona fide* dispute all reveal the debtor's direct, objective challenge to the creditor's claim of debt asserted in the bankruptcy petition. Illustrative is *Matter of Busick*, 831 F.2d 745 (7th Cir. 1987). Creditors filed a petition against a husband and wife on a variety of debts, claiming in essence that the wife was liable for the debts incurred by the husband in his business. The debtor-wife "raised substantial questions as to all of" the creditors' claims. *Id.* at 750. Endorsing the *Lough* test, the Seventh Circuit held a *bona fide* dispute existed, because the wife "has therefore raised claims which, when assessed by an objective standard, raise a reasonable contention 'as to the application of law to undisputed facts.' *Lough*, 57 B.R. at 997." The mere existence of a general counterclaim not on the debt at issue "does not controvert the claim upon which the [involuntary] petition rests," because "the existence of counterclaims does not establish that a claim is the subject of a bona fide dispute" under § 303(b). *In re Onyx Telecommunications, Ltd.*, *supra*, 60 B.R. at 498. Instead, a counterclaim "merely serves to offset the amount owing *if the counterclaim is proven.*" *Id.* (emphasis added).[9]

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9. *See also*, *In re Ferri*, 59 B.R. 656 (Bkrtcy.E.D.N.Y. 1986) (debtor's counterclaim of attorney's malpractice is *bona fide* dispute of debt for attorneys' fees alleged in bankruptcy petition); *In re Cates*, 62 B.R. 179 (Bkrtcy.S.D.Tex. 1986) (debtor's dispute of term of equipment lease and assignor's disclaimer creates a *bona fide* dispute to creditor's petition based on default in payment on the lease); *In re Owens*, 151 B.R. 865

Therefore, the relevant circuit court authority is consistent in holding that Seko's only means of refuting a debt alleged in the petition is by establishing the *bona fide* existence of a legal or factual dispute that goes directly to that debt. A collateral, general counterclaim, whether insurance bad faith or any other contract or tort claim, does not defeat or diminish the *bona fides* of the debt upon which Chicago Title petitioned. Again, such a counterclaim may be efficiently resolved in the same bankruptcy proceeding, assuming the counterclaim is permissible under general principles of law, but the debtor's mere raising of such a counterclaim is insufficient to defeat the creditor's standing to bring the involuntary petition in bankruptcy.

To circumvent the substantial weight of authority cited and followed by the Ninth Circuit, Seko stirs debts arising from the promissory notes into the stew of the collateral insurance bad faith counterclaim, and argues, "In substance, all of the claims at issue arise out of insurance contract transactions." Petition at 10, ¶ 1. As discussed above, this is factually and legally incorrect.

Seko then cites this Court's opinion in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S.Ct. 286, 133 L.Ed.2d 258 (1995), as offering support for the argument.

(Bkrtcy.E.D.Tenn. 1992) (debt arose out of sale of business, and debtor disputed what was sold to incur that debt); *In re Hope Communications, Inc.*, 59 B.R. 939 (Bkrtcy.W.D.La. 1986) (debtor disputed creditor's claims of commissions due creditors on radio station advertising).

That case provides no such support, however.[10] The issue before the Court in *Citizens* is whether a bank's placing an "administrative hold" against the depositor-debtor's checking account upon the debtor's default on a loan owed the bank, while the bank seeks relief from the automatic stay provisions of the Bankruptcy Code, violates the stay. The unanimous Court concluded the hold did not constitute a setoff, and hence, the bank did not violate the automatic stay of 11 U.S.C. § 362(a)(7). The case does not address the criteria for an involuntary petition for bankruptcy under § 303(b), nor any other issue germane to the present proceeding.

CONCLUSION

The Ninth Circuit's opinion is in complete accord with the text of § 303(b), its legislative history as discussed in the opinion, the holdings of other courts around the country, the underlying purposes of the statute, and the logic of distinguishing a debtor's counterclaim challenging the debt alleged in the bankruptcy petition from any other counterclaim the debtor claims. Under these circumstances, no good reason or cause exists for this Court to review the opinion below.

Therefore, for reasons set forth hereinabove, Chicago Title respectfully requests this Court to deny Seko's petition for

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10. Seko purports to quote from *Citizens Bank of Maryland v. Strumpf, supra*. Petition at 10, ¶ 3. The passage Seko quotes is not found in that case, however. The quotation is actually from *Studley v. Boylston Natl. Bank*, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L.Ed. 1313 (1913), an inapplicable case which discusses setoff in general.

writ of *certiorari* to the United States Court of Appeals for the Ninth Circuit.

Dated: March 12, 1999.

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